

# Equity Compensation and Planning Considerations



# Table of Contents

<b>Introduction</b>	<b>2</b>
<b>Glossary of Terms</b>	<b>3</b>
<b>Common Types of Equity Compensation Plans</b>	<b>4</b>
Employee Stock Options (ESOs)	4
ISOs and NSQOs	4
How to Exercise ESOs	5
Restricted Shares	5
Single-trigger vs. Double-trigger RSUs	7
Tax Considerations of ESOs and RSUs	8
<b>Section 83b Elections</b>	<b>9</b>
ISOs and NQSOs	10
RSAs	10
<b>I own the shares, now what?</b>	<b>11</b>
Concentration Risk	11
Exercise and Hold	11
10b5-1 Plans	11
<b>What other types of Equity Compensation are There?</b>	<b>12</b>
Employee Stock Purchase Plans	12
Private Company Stock	12
Qualified Small Business Stock (QSBS)	13
Phantom Stock	13
<b>Conclusion</b>	<b>14</b>

# Introduction

Not all compensation takes the form of a salary or bonus. Many companies, from startups to Fortune 500 companies, allow their employees to take ownership in the company through stock awards, employee stock purchase plans, stock options, and other forms of equity compensation. This is not a new concept. Equity compensation has long been a part of employee compensation and might be one of the main reasons why an employee chooses to take a job in the first place. Equity compensation is becoming a larger part of the total benefits package and often discussed along with health insurance, vacation days, workplace flexibility and more. All of these benefits are nice and important considerations, but you cannot always pay the bills or buy a new home with them.

Despite the uptick in employee ownership offerings, employee education and familiarity around these offerings appears to be falling behind. We find that many Modera clients need help evaluating how their specific equity compensation types fit into their portfolio and overall financial plan. The sea of acronyms, tax issues, timing issues and more can make equity compensation very confusing, and without being properly educated about their benefits, these offerings may seem like more trouble than they are worth.

It is important to remember that one size does not fit all when it comes to equity compensation. Our goal is to help familiarize you with some of the terms, phrases, and strategies to help you feel empowered to make educated decisions about your equity compensation, along with your Modera team.

Before we get started, please take a moment to review the [glossary of terms](#) to familiarize yourself with some of the most used vocabulary in this paper.

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## Glossary of terms

<b>Equity Compensation</b>	A compensation plan that pays employees in some form of company equity, such as common stock, restricted stock units, or stock options.
<b>Exercise (Strike) Price</b>	Also referred to as the “strike price,” this is the price you pay to buy your company stock when your option rights vest or become available to you. Often the exercise price is set at the market price at the time the options are granted.
<b>Market Price</b>	The price of the stock as quoted on a major market exchange. In the case of a private company, the market price is determined by an independent evaluation, often as part of a financing round.
<b>Grant Date</b>	The date when the company awarded you the equity or option, and likely set the exercise price based on fair market value of this date.
<b>Vesting / Vesting Date</b>	A process of gaining full rights or access to ownership. Vesting can happen immediately, but vesting often happens according to a vesting schedule for equity compensation. The vesting date is the date on which the equity award becomes available to you, prior to this date the award is considered unvested.
<b>Vesting Schedule</b>	A schedule that lays out when your stock options or the restricted stock become available. Common examples are four-year vest schedules where a portion of the shares granted vest each year on a preset date.
<b>Call Option</b>	Gives the holder the right, but not the obligation, to buy shares at a pre-determined (strike) price. If the current market price is below the strike price (out of the money) then the option expires worthless since the holder could simply buy the shares on the open market at a lower price than the strike.
<b>In the Money</b>	A call option is “in the money” when the stock’s current market price is higher than the exercise (or strike) price.
<b>Out of the Money</b>	A call option is “out of the money” if the current market price is below the exercise (or strike) price.
<b>Key Employee</b>	Employee with major ownership and/or decision-making role in the business.
<b>Alternative Minimum Tax (AMT)</b>	Separate tax system that requires some taxpayers to calculate their tax liability twice. First, under ordinary income rules and then under the AMT. The taxpayer will pay whichever is higher.
<b>83(b) Election</b>	A provision under the Internal Revenue Code (IRC) that gives the recipients of restricted stock the option to be taxed on the difference between the fair market value (FMV) of their award on the date it was received and the purchase price, rather than on the date it vests.

# Common Types of Equity Compensation

## Employee Stock Options

### What are Employee Stock Options (ESO)?

Compensatory employee stock options (ESOs) are equity call options that are issued by one company to their own employees. It is common for ESOs to have vesting schedules associated with them. This means that the employee must wait a certain amount of time before the shares are owned outright by the employee. The vesting schedule is dictated by the employer but two common schedules are over three or four years.

There are many reasons why a company might issue stock options to their employees, but one is to incentivize good performance and reward seniority. Early-stage companies often will grant stock options in lieu of higher salaries as a promise for greater appreciation as the company matures. In such scenarios, sometimes the exercise price is set below the market price to allow the option holder the potential to profit from an immediate sale after the option is vested and exercised (though this scenario may result in additional tax consequences for both the company and employee).

### There are two types of compensatory employee stock options: ISOs and NQSOs

- 1 **Incentive Stock Options (ISOs)** are typically awarded to senior executives and key employees. These options allow employees to purchase a set quantity of company shares at a specific price, while enjoying favorable long-term capital gains tax treatment if held for specific periods of time (see table below for summary of tax treatment).
- 2 **Non-Qualified Stock Options (NQSOs)** can be awarded to senior executives but, more commonly used for other employees. NQSOs generate taxable ordinary income upon exercise on the gain if the exercise price is greater than the strike price.

The option grant agreement that your employer provides you will specify the types of shares you have. It will also dictate the vesting schedule associated with the options.

## How do you exercise employee stock options?

There are a couple of ways to exercise your equity options and there is not a one-size-fits-all approach. The right strategy will be one that fits with your goals and objectives. With Modera’s comprehensive financial planning approach, our team will often model and evaluate the impact of your equity compensation within the context of your financial plan. This enables you to assess the potential impact of your decisions and see how they affect your cash flow and future balance sheet. With that in mind, we will outline a few common scenarios that may be useful as you evaluate your options.

**1** **Cash Exercise** is a simple method of using outside cash to make the purchase.

**2** **Cashless Exercise** is when some of your shares from the vesting lot are sold in order to generate the amount of cash needed to purchase and ultimately exercise the shares.

### Let’s see how each of these strategies works in the example below:

→ An employee was awarded (granted) 1,000 options with a 4-year quarterly vesting schedule in January of this year. The strike price for these shares is \$50. On March 31, the employee expects to get 62.5 shares. The price of the stock on the day that it vests is \$75.

- If using a **Cash Exercise**, the employee will be required to have \$3,125 (62.5 shares x \$50) on the day of vest to fully purchase and own all the shares. The market value of the shares after the exercise is \$4,687 (\$75 x 62.5 shares)
- If using a **Cashless Exercise**, the employee will be required to sell 41.667 (@ \$75/share = \$3,125) shares on the day of vest in order to purchase and own the remaining shares. The employee will then own 20.833 shares in their account valued at \$1,562 (\$75 x 20.8333)

#### 1,000 Options | Market Price = \$75 | Strike Price = \$50

Cash Exercise	Cashless
<p><b>\$50K</b> from bank to buy all 1,000 Shares</p> <p><b>\$50K</b> less in the bank</p>	<p style="text-align: center;"><b>1,000 Shares</b></p> <p style="text-align: center;"> <span>\$667 to buy</span> <span style="margin-left: 100px;">\$333 to keep</span> </p>

## Restricted Shares

Restricted stock is another form of equity compensation that companies issue to employees. There are two types of restricted shares: restricted stock awards (RSAs) and restricted stock units (RSUs).

- 1 **Restricted stock awards** (or RSAs) are typically granted to company directors or executives by early-stage companies when the valuations are still very low. Once the shares are awarded and vested, the employee will own the shares on their personal balance sheets. Since they are “restricted,” the shares cannot be freely transferred or traded without company approval. RSAs are taxed as ordinary income at FMV at the time of vesting, unless an 83b election has been made within 30 days of the grant. Any shares held after vest are subject to Capital Gains tax rules.
- 2 A more commonly used type of restricted share is a **Restricted Stock Unit** or **RSU**. RSU’s are NOT equity, rather they are a promise from your employer to give you shares of the company’s stock (or the cash equivalent) on a future date—as soon as you meet certain conditions, such as continued employment. Unlike restricted stock awards, RSUs are not actual stock, so if dividends are issued the employee will not receive them until the RSUs vest. RSUs are not eligible for 83b treatment, so are taxed as ordinary income at the time of vesting. Any shares held after vesting are subject to Capital Gains tax rules.



## Single-trigger vs. Double-trigger RSUs

RSU shares are not issued to the recipient until they vest and are settled by the company and can have multiple vesting conditions. If your RSUs have a single-trigger vesting schedule then you typically only need to satisfy a single, time-vesting requirement.

RSUs can also be subject to double-trigger vesting. A common additional vesting condition for RSUs is a company liquidity event, such as an acquisition or initial public offering (IPO). With this type of double-trigger vesting, both conditions must be satisfied for your shares to vest. This allows the employee to delay their tax obligations until the shares have appreciated so that they can sell some shares to offset their out-of-pocket tax payments.

Equity granted in a private, startup company that is approaching an IPO is commonly subject to double-trigger restrictions. The vesting and taxable event does not occur until both requirements are met.

### Public Company (single-trigger)

- At Grant - no tax
- At Vest - taxed as wages
- At Sale- difference between value at vest and sale is CG/CL

### Private Company (double-trigger)

- 1st trigger is vest - but unlike above, not taxable
- 2nd trigger is Liquidity event - this is when it becomes taxable

RSA	RSU
Company shares issued at grant	Company shares not issued until vesting
Voting rights gained at grant	No voting rights until vesting
Employee may need to pay for the grant	Employee not required to pay for the grant
Build wealth by “buy low sell high”	Build wealth by selling shares acquired with no cost
Eligible for Section 83b election Helps avoid ordinary income tax	Not eligible for Section 83b election: Ordinary income tax necessary
Unvested shares can be purchased back from employees at termination	Unvested shares will be forfeited at termination
Common in Startups	Common in established companies (Private & Public)

## Summary of Tax Considerations of ESOs and RSUs

ISOs	NQSOs	RSUs
At the time of exercise, there are no “regular” tax consequences, though there may be AMT consequences	At the time of exercise, the difference between the exercise price and the market price is taxed as ordinary income.	At the time of vesting the total value of the shares will be taxed at ordinary income rates.
The basis of the stock received is equal to the exercise price paid.	The basis of the stock received is equal to the market price on the day of exercise.	The basis of the stock is the market price on the day that it vests.
The difference between the exercise price and the market price on the day of exercise increases the employee’s alternative minimum taxable income.	There are no alternative minimum tax consequences.	STCG will be due on any sales post vest within 12 months. LTCG will be due on any sales beyond 12 months.
No step-up in basis is available at death for unexercised options.	No step-up in basis is available at death for unexercised options.	
Except in the case of a disqualifying disposition (see below), all appreciation from the exercise price is taxed as long-term capital gain.	<p><b>Disqualifying Dispositions of ISOs</b></p> <ol style="list-style-type: none"> <li>1. Results when stock received from an ISO is sold, or otherwise disposed of (including being gifted or being used to swap in for an ISO exercise), within two years of the option grant date or within one year after the option is exercised.</li> <li>2. ISO shares may be swapped in to exercise a non-qualified option (but not an ISO) within one year of exercise without triggering a disqualifying disposition.</li> <li>3. AMT consequences for ISOs depend on whether the disposition occurs in the year of exercise or in the following year.</li> </ol>	
Basis for AMT purposes is higher than for regular tax purposes.		

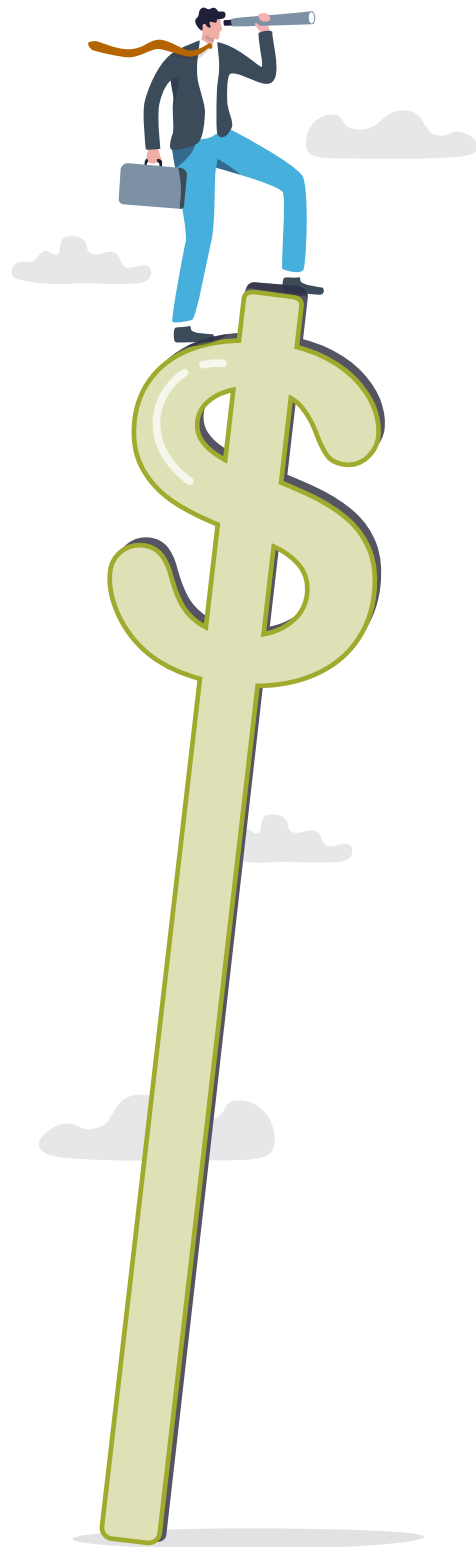
# Section 83(b) Elections

Section 83(b) of the Internal Revenue Code (IRC) enables recipients of restricted securities (including stock options) to potentially lower their tax burden by paying taxes on the total fair market value (FMV) of the award at the time of issuance (early exercise) rather than at the time of vesting. Employees and founders must file an 83(b) election form with the IRS to get this favorable tax treatment.

Typically, one would have 30 days from the grant date to make the 83(b) election after issuance of Restricted Shares (RSAs, not RSUs) and ISOs and NQSOs. The action allows you to pay ordinary income tax upon receipt of the stock rather than when it vests. Any appreciation thereafter is taxable at the more favorable capital gains tax rates.

## **83(b) Strategy**

- Prepay tax sooner and at a potentially lower dollar value
- Your hope is to take advantage of capital gains tax treatment and minimize ordinary income taxes and AMT
- It might not have been a good idea to file an 83(b) election if the value of the stock falls, the company files for bankruptcy or the employee leaves the employer before the stock fully vests.



## Tax Implications of an 83(b) Election

### ISOs and NQSOs

With these two types of stock options, you might file an 83(b) election if you decide to exercise your options early, before they are fully vested. When you do, you are basically accelerating the spread between the strike price of your options and their fair market value (FMV). That means you are not paying taxes on any potential rise in that spread as your shares continue to vest over time. If you do not file the election, though, it is as if your early exercise never happened.

If you have incentive stock options (ISO) when you file an 83(b) election, the spread between the FMV and your exercise price is included as income for the alternative minimum tax (AMT). Without an 83(b), you may have to pay AMT on the spread between the strike price and the FMV as you continue to vest — instead of the spread at early exercise. This could potentially trigger the AMT or lead to a higher AMT.

If you have non-qualified stock options (NQSOs), that same spread is income for ordinary income tax purposes. Failing to file 83(b) election will mean that you will be subject to a higher income tax rate if the FMV increases as your options vest.

### RSAs

Founders and very early-stage employees often receive restricted stock awards (RSA). The value of these can vary based on the company's FMV, but they are typically issued at a nominal value (like \$0.001 or \$0.0001 per share). This means that if you file an 83(b) election when you receive your RSAs, you are likely to have very limited tax liability because you are recognizing that spread (which is zero or very small) as ordinary income tax up front. When you eventually sell these shares, you will be subject to capital gains tax on the difference in FMV at the time of sale. Without an 83(b) election, the spread between the FMV at vest less your purchase price would be subject to ordinary income tax.

# I own the shares, now what?

## Beware of Concentration Risk

If you believe in the long-term future of the company, holding the company stock you earned via your equity comp package will allow you to participate in the appreciation of the stock over time. Over time, you will want to monitor and evaluate the concentration of the position on your personal balance in order to avoid an over concentration of the stock in your investment portfolio. This can be a risk to your financial security, especially as you get closer to your retirement. As with any investment strategy, it should be monitored closely, and a strategy should be defined as you decide to sell or diversify.

## Exercise and Hold

We have already learned that stock options do not immediately vest like restricted shares. Depending on the lifecycle of the company, it could make sense to exercise the stock options you have and hold them. If you exercise your stock options when a new company is in its early stages, the share price could increase substantially. There are many factors to consider with this approach and you should evaluate the impact of this approach with your Modera team.

## 10b5-1 Plans

10b5-1 plans are used by insiders that receive equity compensation. Insiders can include company officers, directors and individuals who own more than 10% of the company's shares. If you qualify as an insider, your company will alert you so you can establish a 10b5-1 plan. 10b5-1 plans set out an automatic, predetermined program for the periodic purchase and/or sale of employer stock options. Sometimes those who have material non-public information about their company stock are subject to restrictive trading windows. 10b5-1 plans allow the employees to periodically trade their company stock while being mindful of their Company Trading Policy.

# What other types of Equity Compensation are there?

## Employee Stock Purchase Plans

An Employee Stock Purchase Plan (ESPP) allows an employee to buy shares of their employer's stock directly via their paycheck, typically at a discount from the current market price. It is important to keep in mind is that there is a maximum annual amount that the IRS will allow an employee to purchase via an ESPP. Your employer should tell you what the maximum amount is that you can purchase annually.

## Private Company Stock

Nearly every operating business in the U.S. has started as a privately held business. They come in all shapes, sizes and industries. All companies need capital and while both public and private companies might utilize loans and other types of funding, only public companies can sell shares or raise money to the general public to promote growth.

Both public and private companies can issue stock and are owned by their shareholders. Shareholders may include the company's management or any other people who have a stake in the company. Being private means that a company's owners retain control and are not subject to scrutiny from regulators. It also means that they cannot raise money through capital markets to fund their growth or pay their debts. If you wanted to invest in a private company, their shares are not available for purchase by the general public. This means that the shares of private companies are less liquid, and their valuations are more difficult to determine as they do not meet the Securities and Exchange Commission's (SEC) strict filing requirements for public companies.

→ When you purchase stock of a very early-stage company, there may be a need for a tax strategy to avoid gains when the stock is sold.

## Qualified Small Business Stock (QSBS)

Qualified Small Business Stock (QSBS) is a type of stock issued by a C corporation business (C-Corp) that meets requirements in the Internal Revenue Code, specifically Sections 1202 and 1045. QSBS offers substantial tax benefits to shareholders, most notably founders and early investors. If you own this type of stock and then you sell it, you could avoid paying federal income taxes on the money you make from the sale, up to a certain amount.

The QSBS exclusion is a U.S. tax benefit that applies to eligible shareholders of a qualified small business. Founding, investing in, and working for a startup can be riskier by nature, the QSBS exclusion offers tax benefits to those that take that risk. The QSBS tax exclusion is set forth in Section 1202 of the U.S. Internal Revenue Code. When shareholders sell or exchange their qualified stock, the exclusion can provide an exclusion of up to 100% of tax on capital gains.

### **A company is known as a qualified small business when it meets the below qualification requirements:**

1. The company must be an active business that is incorporated as a U.S. C-corporation.
2. The company must have had gross assets of \$50 million or less at all times before and immediately after the equity was issued.
3. At least 80% of a company's assets must be actively used in a qualified trade or business. There are businesses that are excluded per the IRS (service related, farming, owner image, etc.)

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➔ **If you come across a situation where the stock is considered QSBS, please reach out to your Modera Team and we will help you connect with the best individuals to evaluate your options**  
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## Phantom Stock

The last type of stock that we will review is phantom stock. This type of equity compensation gives the employee the economic benefits of being a stockholder without the legal ownership rights of shares. This can also be known as phantom equity, phantom units, or phantom shares.

Phantom stock is tied to a company's performance but promises a cash payment at a future date based on the market value of the stock at the time. As a result, the income is taxed at ordinary income rates and not capital gains rates. The amount of the income can increase or decrease as the stock price changes.

# Conclusion

More and more employers (public and private) are offering equity compensation benefits to their employees. Receiving a portion of your compensation in equity might sound relatively straightforward (and exciting if it is a highly appreciating stock) but the mechanics can become complicated quickly. Our goal was to introduce the main types of equity compensation plans and strategies to maximize your benefits. Please continue the conversation with your Modera Team to determine which strategies may or may not make sense based on your personal circumstances.

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